C.D. Howe Institute

Commentary

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THE FEDERAL BUDGET: ALL THINGS TO ALL PEOPLE?

Summary: In preparing the forthcoming federal budget, policymakers face two major challenges. One is to establish an environment that encourages private-sector investment and creates new jobs. The other is to slow the growth of federal debt by cutting the deficit. Other economic policy decisions affecting trade, investment, and energy will make the job easier. But there is no substitute for the tough fiscal decisions that are essential to reduce the deficit and Canada's vulnerability to international economic pressures.

Few economic policy statements in Canada have received as much buildup or have created such diverse expectations as the federal government's budget, scheduled for the week of May 20, 1985. In preparing the budget, the government faces a few very tough decisions. Wisely made, these decisions will improve Canada's long-term growth prospects.

In extensive consultations with Canadians, the federal government has received conflicting advice about policy objectives and instruments, and has heard concerns about the future of Canada's social programs. Not unexpectedly, the special interests represented at the National Fconomic Conference were unable to reach consensus on Canada's economic policy priorities. The conference did, however, generate greater understanding of the reasons for different points of view. Australian Prime Minister Robert Hawke, who was a guest at the conference, eloquently expressed the purpose of such consultative efforts:

> I cannot stress too much the fundamental importance of this aspect of our approach. We live in a period of the most dramatic change in recorded history. Our institutions and their members bring to the tasks of today, attitudes, assumptions and expectations that have so often been fashioned in an earlier generation which in so many important respects bears no resemblance to the economic realities of today -- or tomorrow. These attitudes can, therefore, not only lack relevance, but can be positively counterproductive -- many groups have the power to distort and even to veto particular changes which are essential parts of the wider mosaic of economic growth.

This round of consultation has concluded. The federal government, having listened to diverse points of view, must now act in the national interest. The purpose of this **Commentary** is to consider the national priorities upon which the budget should be evaluated and to assess the probability that the budget will address these priorities. The Progressive Conservative government's existing policy record is mixed. It has taken some major new initiatives to stimulate future growth prospects. But it has reduced the impact of these initiatives by vacillating on tough decisions that serve the national interest when they have conflicted with special interests.

Canada's Problem

The C.D. Howe Institute, both in its published and unpublished contributions to the government's consultative process, has addressed two main objectives for national economic policy: first, to restore sustainable economic growth and, second, to reduce Canada's vulnerability to such external threats as recession in the United States, increasing protectionism, and unexpected price shocks. These objectives are closely interrelated; one cannot be achieved without the other. Key steps to achieving them are lower federal government deficits and reduced protectionism at home and abroad.

Furthermore, achievement of both objectives is necessary if Canadian living standards are to improve in the years ahead. Canada is a trading nation in an increasingly competitive international environment, one that is characterized by low inflation, rapid technological change, and shifting patterns of comparative advantage. Competitive pressures from the newly industrializing countries, continuing high real interest rates, and a strong U.S. dollar are creating inexorable pressures on all industrial countries, including the United States. The resulting pressures on employment are stimulating protectionist responses.

Canada has experienced moderate but unevenly distributed economic growth since the 1981-82 recession. Fueled by the booming U.S. economy and a low Canadian-U.S. exchange rate, exports have led the recovery, but Canadian consumers have contributed to growth as well. Productivity has rebounded from its dismal performance of the late 1970s and early 1980s, but remains below par when compared with its average performance during the past 25 years. Inflation has dropped to the same level as that in the United States, and may drop lower. But unemployment remains at 11 percent nationally and the small improvement since 1982 has not been evenly shared. In British Columbia, for example, the unemployment rate has continued to climb and now stands at 15 percent.

The most troubling aspect of Canada's recovery has been the stagnation of private capital spending, which has contributed greatly to the persistence of high unemployment and delayed the process of industrial modernization and adjustment to changing competitive conditions. The federal government, in its economic strategy unveiled in November 1984, addressed this problem by committing itself to restore market forces and reduce the size of the public sector. Economic performance since then has continued to underline the importance of reviving private-sector investment if Canada is to improve both its immediate and long-term prospects. For these reasons, investment is a core issue which the budget strategy will have to address.

From the mid-1960s until the 1981-82 recession, Canada allocated an average of 14.5 percent of its national income to business nonresidential investment -- the basic building block of the nation's productive capital stock that generates growth. This share dropped to 13 percent in 1984 from 16 percent in 1982; Statistics Canada's recent survey of business capital spending intentions indicates that it is likely to remain at this low level in 1985. The magnitude of the problem is illustrated by comparison with investment performance in the United States, where the share of national income allocated to business investment, which averaged 10.5 percent from the mid-1960s until the latest recession, increased to 13 percent in 1984 from 11 percent in 1982. The surge in U.S. investment has contributed to a strong recovery in that country and has facilitated the reallocation of resources into the faster-growing technology and information-intensive industries from those experiencing declining international competitiveness.

International economic conditions largely beyond our control have contri-

buted to the recent stagnation of business investment in Canada. Among the most important of these external factors are continuing high real interest rates and declining raw materials prices.

Interest rates, adjusted for inflation, have been in the 7-8 percent range during the last six months, higher than at any time since mid-1981. New capital investment makes financial sense when the real after-tax rate of return expected on a project exceeds the real interest rate that could be earned by holding low-risk bonds. In the current environment of high real interest rates, however, investment projects unable to generate a high threshold rate of return simply do not go ahead.

Canada's interest rates are determined primarily by rates prevailing in world financial markets, especially in the United States. Canada's ability to keep its interest rates below U.S. rates depends on the confidence investors have in the safety of and return on Canadian assets. Lower interest rates would be possible if Canada could boast of an attractive and stable climate for investment, a lower inflation rate than our major trading partners, and a credible strategy for reducing government deficits.

A second external factor depressing business investment in Canada is the weakness of raw materials prices in world markets. At the end of 1984, Statistics Canada's index of the price of Canada's exports of crude materials such as fuels, minerals, and timber stood about 15 percent below the level of mid-1982. Low prices, in the absence of even larger cost reductions or productivity increases, have forced closures of mines and mills and have made potential new investment projects unprofitable.

It would be a mistake to interpret the current weakness of commodity prices as entirely a short-term, cyclical phenomenon. Large increases in commodity prices in the 1970s and early 1980s have led to increased efficiency in the use of raw materials and significant increases in supplies from developing countries. Thus, increased investment in raw materials industries, where it is occurring, is aimed at reducing production costs to restore competitiveness.

High real interest rates and weak raw materials prices also have had the effect of dampening domestic income growth and consumer demand. Capacity utilization remains low in most industries, with the exception of export-oriented manufacturing industries that have benefited from strong U.S. demand.

While there is some prospect for improvement in the external environment in the medium term, it is no longer possible to rely on low real interest rates or strong export prices for raw materials as the engines for private investment and job creation in Canada. The newly emerging imperatives driving investment are, first, the need for international cost competitiveness in the production of raw materials and basic manufacturing and, second, the need to shape new areas of comparative advantage through research and innovation in advanced manufacturing and the services industries.

Budget Priorities

Canada faces serious strategic challenges to increase its adaptability and resilience, to break its structural restraints, and to restore growth momentum. The federal budget will be a key policy instrument, although not the only one. If it is to address these challenges, the budget will have to focus on encouraging investment while observing public concerns about fairness and the maintenance of social programs.

Policies that reduce the uncertainties associated with investment can be implemented without extensive new budgetary incentives. An improved investment climate can be achieved in two ways: through a credible strategy that grad-

ually reduces the federal deficit and thereby releases savings to finance private-sector investment; and through reduced intervention in private-sector investment decisions.

One alternative that has received attention, but that the Institute does not recommend, is to stimulate consumer spending by pushing down the personal savings rate. While stronger consumer spending would help to revive investment, using policy to push down the personal savings rate is risky for several reasons. First, there is a danger that the issue may be wrongly defined. In Canada, the issue is not that the personal savings rate is too high but, rather, that the rate of return to savers is too high relative to the rate of return to investment. Second, such policy action could undervalue the role of personal savings in the growth process. Savings are required to meet public-sector borrowing requirements and to finance business investment. Reducing savings incentives by, for example, limiting the tax deductibility of RRSP contributions would reduce permanently the savings pool needed to finance economic growth. The end result could easily be higher interest rates in future, little contribution to current growth, and reduced future prospects.

The real issues, as the Institute pointed out in the recently published **Policy Review and Outlook, 1985**, are to improve the climate for investment by holding down inflation, reducing the deficit, and removing policy uncertainty; and to find ways to channel Canadians' savings into equity.

Deficit Reduction

Gaining control of the federal budget deficit is critical to reducing the uncertainty facing private investment in the next few years. Until Canada adopts a credible strategy for reducing the deficit, Canadian business is unlikely to be convinced that growth will be sufficiently strong to justify a significant increase in new investment.

Canadians have been slow to realize that persistent deficits, even though they can help fuel a recovery, are obstacles to longer-term growth. Such deficits raise the cost and reduce the availability of funds to finance investment because government borrowing requirements to finance the deficit absorb the lion's share of private savings. In 1984, approximately two-thirds of net private savings was used to finance the deficit, compared with less than 20 percent in 1981. Every dollar that the federal government borrows to finance its current operating expenditures and transfer payments means one less dollar available for investment in modern facilities, machinery, and equipment that can create jobs and improve productivity.

There are no painless ways to reduce the deficit. Either spending has to be restrained or taxes increased. Each would cut the deficit and reduce the vulnerability associated with the rapid accumulation of public debt. But only expenditure restraint can release savings to the private sector and lead to stronger investment and growth. A general tax increase would merely replace borrowing without freeing any resources for investment. In the process, higher taxes would depress consumer and business confidence and weaken the economy.

How Much Reduction?

The spending cuts announced in the federal government's November 1984 **Economic and Fiscal Statement** served to contain but not reduce the deficit. The decision to terminate the special research and development tax credit, which gave rise to so-called "quick flips" and which cost the federal treasury almost $1 billion, helped slow the erosion of federal tax revenues. Without further action in the May budget, however, the deficit will remain around $35 billion per year for the rest of the decade.

Deficits of this magnitude represent a major source of vulnerability threatening Canada's prospects for sustained growth. Each year the government has to borrow $35 billion to finance its deficit, it adds this amount to the total federal public debt, which now stands at $190 billion. Such a large public debt makes the federal government's finances -- and the Canadian economy as a whole -- extremely vulnerable to the high and volatile interest rates set in world financial markets. If interest rates remain above 10 percent, the rising public debt will exact an increasing interest burden on the federal government. Already, one dollar out of every three of federal revenue is used to pay interest on the debt. If interest rates moved higher for a sustained period, higher interest costs would greatly worsen the deficit, forcing spending cuts and tax increases when the economy could least afford them.

Canada need not be exposed to such risks. Prompt action to reduce the deficit could slow the growth of both the debt and federal interest payments. A reasonable target would be to slow the growth of the debt so that it no longer exceeds the growth of the economy. The Institute has estimated that reducing the deficit by $15-20 billion by the end of the decade would achieve this target.

A Strategy for Reduction

If deficit reduction in the May budget is to focus primarily on the spending side, as Finance Minister Wilson has repeatedly indicated it should, public acceptance requires that the burden of restraint be broadly distributed. Every effort needs to be made to demonstrate to Canadian taxpayers that the government is doing its part to improve efficiency, cut waste and duplication, and contain costs. The Nielsen Task Force's recommendations on improving the efficiency of government programs will be a critical element of a credible deficit reduction plan: if the government is unable to convince Canadians that it is improving its own management, it is unlikely to convince them of the need for restraint in politically sensitive personal transfers such as child benefits and pensions, and provincial transfers for health, education, and welfare. In the same way, some changes in the tax system will be required to convince middle-income Canadians that high-income earners are bearing their share of the burden of deficit reduction. These could include the implementation of a minimum tax both on persons and corporations to eliminate situations in which wealthy individuals and profitable corporations pay no tax.

A strategy of fairly spreading the burden would involve most sectors of Canadian society, including the federal and provincial governments, as well as individuals and businesses receiving federal grants or transfers. Properly designed, however, such a strategy would also target benefits more efficiently while fully protecting low-income Canadians.

A program to reduce the deficit by $15-20 billion by the end of the decade should assist growth and efficiency while observing the main concerns expressed in public consultations about fairness. Such a program should be expected to include the following combination of spending cuts and tax measures:

- Improved management within the federal government aimed at restraining compensation and operating costs, reducing payments to money-losing Crown corporations, ending program duplication, and improving cost recovery through increased user fees, which together could save $3 billion by the end of the decade.
- Reduced grants and subsidies to Canadian business, including the phaseout of the Petroleum Incentives Program, which could contribute $2.5 billion in expenditure reductions by 1990.
- Reduced inflation indexation of personal transfers -- including Old Age Security (OAS) and Family Allowance (FA) -- so that payments are only automatically increased if inflation exceeds 3 percent,

which could save $2 billion per year by the end of the decade. Low-income recipients of OAS and FA should be protected by increasing the Guaranteed Income Supplement and Refundable Child Tax Credit so that they are fully compensated for cost-of-living increases.

- A reduction in escalation factors for federal transfers to the provinces by 3 percent, consistent with the change for personal transfers, which could reduce spending by $2 billion per year by 1990.
- Amended tax rules to incorporate a minimum tax on individuals and corporations -- pending a complete review of all tax expenditures -- and a reduction in the indexing of the personal tax, which together could raise $4-5 billion in additional tax revenue each year by the end of the decade.

If all of these measures were adopted, the resulting lower deficits would slow the growth of the federal debt and thereby reduce interest payments by $2-3 billion per year by the end of the decade.

This strategy for deficit reduction has several advantages. It starts with improved program management and cost control in the federal government. It spreads the burden widely while protecting the least advantaged. It reduces industrial subsidies that distort business decisions and block economic adjustment. It slows the growth of social benefits while preserving the principle of universal access; no one who currently receives social benefits would lose them. If reforms of the type suggested in the federal government's recent discussion paper on social benefits were adopted, the programs would also be better targeted to low-income recipients.

The provinces, all of which stand to gain higher revenues from reduced indexation of federal taxes, would contribute to deficit reduction by accepting restraint in federal transfers. Upper-income individuals and large corporations would also contribute through the minimum tax. Finally, the program would produce gradual but steady reductions in the deficit throughout the remainder of the decade and add stability to the policy environment.

The Policy Record as a Guide to Budget Strategy

What are the chances that this kind of strategy, involving some tough decisions on spending and taxes, will be adopted? The Institute believes there are two major risks. One is that the private-sector investment response, which is the key link between deficit reduction and stronger growth, may be slow to materialize. The other is that special-interest concerns may prevail over the wider national interest.

One of the key assumptions of the November **Economic and Fiscal Statement** was that the mix of public and private activity is the wrong one to stimulate economic growth. This assumption has been the subject of considerable debate. The government has argued that by freeing up investment activity, deficit reduction will create, not destroy, jobs. Opponents of this view -- who include Keynesian economists, labor leaders, and members of the political opposition -- have argued that deficit reduction will be recessionary; they assume reduced government spending will reduce aggregate demand and, therefore, the demand for labor.

The Institute has argued that there can be a positive link between deficit reduction and future growth. One segment of the link involves a temporary accommodation of monetary policy to help offset the effect of fiscal restraint. Canadian interest rates would continue to be heavily influenced by U.S. rates. But a credible strategy for deficit reduction would contribute greatly to the Bank of Canada's ability to bring down domestic interest rates so that they no longer exceed U.S. rates. Such a strategy would also enable Canada to benefit fully from reductions in U.S. interest rates brought about by actions to reduce the budget de-

ficit in that country. Another segment involves the creation of a climate in which the private sector can take full advantage of the increased availability of financing and the reduced uncertainty that lower deficits would bring.

An examination of the policy record since November provides useful insights about the chances that either of the risks associated with deficit reduction will materialize. The first attribute of the record is that the federal government has recently made some striking progress toward improving the climate for growth and investment in Canada. It has taken bold steps to set in motion what may be far-reaching changes in Canada's trade relationship with the United States. The government has reached energy accords with the provinces that create a fiscal environment highly favorable to investment in the petroleum industry. The Foreign Investment Review Agency (FIRA) is to be replaced.

Bold Steps

At the Quebec Summit, Prime Minister Mulroney and President Reagan made commitments to find all possible ways to reduce and eliminate existing trade barriers between the two countries. Guaranteed access for Canadians to the 235-million-person U.S. market could have a very beneficial impact on investment and jobs in Canada. Decisions to invest would no longer be clouded by the threat that rising U.S. protectionism might limit companies investing in Canada to selling only in the domestic market. Freer trade could also spur new investment to assist the restructuring of Canadian industry in response to new competitive challenges and opportunities. However, the adjustment costs and the impact on Canada's political and cultural sovereignty of closer economic integration will have to be carefully examined; it will thus be some time before specific proposals for such an agreement are likely to be implemented.

More immediate results are likely from two energy accords reached since the beginning of 1985. The combination of depressed world oil prices and extensive regulation of pricing, production, and investment has constrained the petroleum industry's capacity to invest and create jobs. The successful negotiation of the Atlantic Accord with Newfoundland opens the way for development of the Hibernia oil field, if it can be justified on the basis of expected world oil prices. The Western Accord with Saskatchewan, Alberta, and British Columbia dismantles a fiscal and regulatory environment that was discouraging the development of conventional oil and gas located mainly in those provinces. A market-oriented energy policy, by improving the decision-making environment and industry cash flow, is likely to encourage investment. In addition, the location and composition of investment is more likely to be determined efficiently by market considerations than by political incentives.

The new official attitude toward foreign investment embodied in the Investment Canada legislation provides another positive signal to investors. The principal differences between Investment Canada and FIRA are that new investments in Canada by foreigners will no longer be reviewed, and that a $5 million threshold will be established for review of foreign takeovers of existing assets. (Under FIRA, virtually all takeovers were reviewable.) These changes, expected to reduce the number of investment proposals reviewed by 90 percent, mean a welcome reduction in government intervention in small investments by foreigners in Canada.

Mixed Signals

In addition to these bold steps, however, the policy record contains some disturbing indicators of mixed signals -- toward investors and toward making "tough" decisions. These indicators underline the risks to be run in making May budget decisions that, while not univer-

sally popular, serve the national interest. More specific matters of trade, industrial, and investment policies provide examples of indecisiveness.

At the time this **Commentary** was written, the government's hesitation to remove voluntary export restraints on Japanese automobiles was sending investors the wrong signal. Canada entered into the export restraint agreement with Japan in 1981, after a similar agreement with Japan had been obtained by the United States. The rationale for a Canadian-Japanese agreement was Canada's concern that the U.S. restraints would divert Japanese exports originally destined for the United States into the Canadian market. That rationale disappeared when President Reagan ended the U.S. restraints in early March 1985.

Canada has hesitated to follow suit, hoping to use its trade restraint agreement as leverage to gain commitments for greater investment in Canada by Japanese automakers. While this concern about investment is valid, the tactic is likely to prove counterproductive. By threatening continuing resort to trade restrictions when the original rationale no longer applies, Canada risks damaging its reputation and trade relations not only with Japan but with other countries that are potential markets for Canadian products as well. The real issue for Japanese investors is guaranteed access to the U.S. auto market from Canada. They perceive state-of-the-art investment in Canada to make sense only if they are able to produce for the entire North American market. Such investment, under the autopact, risks unilateral abrogation by the United States with only one year's notice. In the current environment, in which an increasing number of Canadian industries are vulnerable to unilateral protectionist action by U.S. interests, the Japanese concern about the vulnerability of their investment in Canada is understandable.

Changes to FIRA will do much to improve the atmosphere for foreign investors, but the signals are not unambiguous. The proposed legislation stops short of getting at the heart of the uncertainty created by investment screening of medium and large enterprises. The government can block the sale of assets accumulated in Canada -- either by Canadians or foreigners -- if the potential buyer is not Canadian.

Capital is a highly mobile commodity. Investors seek both safety and flexibility, including the ability to sell their assets at a fair market price in the future. The continued screening by Investment Canada of all sizable transactions involving foreigners reduces the liquidity and flexibility of capital invested in Canada and thereby reduces Canada's relative attractiveness as a place to invest.

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The authors of this issue are Edward A. Carmichael and Wendy Dobson.

C.D. Howe Institute
Glendon Hall
2275 Bayview Avenue
Toronto, Ontario
M4N 3M6

Telephone: (416) 485-4310

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An agency like Investment Canada has a role to play in encouraging investment in Canada and in screening investments that would influence Canadian culture or national security. But limiting the screening of foreign purchases of assets in Canada to a well-defined set of sensitive industries could make a meaningful contribution to stronger investment and job creation.

The government has also given conflicting signals on industrial subsidies. It bailed out Pétromont; after reducing VIA Rail's subsidy last November, it increased the subsidy in January to finance new capital expenditures; it first denied, then agreed to review, Domtar's request for capital assistance.

The use of industrial subsidies injects another form of uncertainty into Canada's investment climate. Firms prepared to invest without subsidization face the risk that potential competitors will gain advantage by securing a government subsidy. This risk was demonstrated when Domtar requested a federal subsidy of $100 million to expand and modernize a fine paper mill in Quebec. A decision by Ottawa to underwrite part of the investment would have placed Domtar's Canadian competitors at a disadvantage while exposing Canada's future fine paper exports to the risk of countervailing duties by U.S. and European interests. Ottawa's indecision on the Domtar request and the fact that billions of dollars remain earmarked in the federal budget for industrial subsidies mean that the uncertainty facing potential investors will remain.

Finally, the policy record on deficit reduction is mixed. A start was made in November, but it was only that. The $4.2 billion in spending cuts and revenue-raising measures merely contained the growth of the deficit. In the public debate that followed, the government vacillated on the tough decisions and confused the issue on social programs. The Prime Minister's refusal to apply savings from the reform of social programs to deficit reduction will make the task more difficult, as will increases in defense spending and passenger rail subsidies. These decisions mean that the burden of deficit reduction will have to be borne by deeper cuts in other areas of federal spending or by tax increases.

Conclusion

Based on Canada's economic performance and what needs to be done to improve it, Canadians should expect a budget that squarely confronts the federal deficit. The policy record shows that on major issues of trade, investment, and energy policies, the government has been prepared to take bold steps to improve the prospects for growth and job creation and to reduce Canada's vulnerability to adverse international developments. These measures, however, are not substitutes for deficit reduction. They are complementary. Initiatives such as these make a credible deficit-reduction strategy easier because they help unshackle the private-sector growth response which many believe deficit reduction endangers. But deficit reduction is an essential ingredient, along with these other measures, to improve prospects for sustainable growth in the long term.

The strategy for deficit reduction that the government chooses will be critical as well. To ensure widespread public acceptance of what is perceived to be a short-term threat to many special interests, the plan will have to spread the burden broadly and fairly. Everyone but the disadvantaged must be prepared to sacrifice in the short term in return for better prospects for sustainable growth in the future. The plan will have to improve management and restraint within government while preserving and strengthening the social safety net. If it is not possible to eliminate subsidies or bailouts, performance requirements should be imposed on these and on contracts, making make them conditional upon achiev-

ing cost-cutting and productivity-raising measures. A well-designed plan can be fair and effective without being all things to all people.

Canada is on the move again. Obstacles to growth are being removed and a start has been made to reduce the economy's vulnerability to external pressures. What remains to be done is to get the fiscal house in order. All Canadians will have to shoulder their fair share because without a tough but realistic budget, there is no one but the next generation to whom to pass the burden.

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